

The Value-Added Tax

A Revenue System for America's Future

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Presented by
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Before the President's Advisory Panel on Tax Reform

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Why Should the Current Income Tax be Replaced?

- It has become a maze of complexity.
 - It is widely perceived as unfair.
 - It has not kept pace with the economic realities of the modern global marketplace.
 - It creates economic distortions, thus interfering with economic efficiency and growth.
 - It does not reach the huge underground economy.
 - It has become burdensome to many taxpayers, particularly small businesses who must struggle through a pile of Federal tax forms every quarter.
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Guiding Principles for a New American Tax System

Any alternative to our current tax system must satisfy four fundamental criteria. No proposal that violates these principles should be entertained.

Revenue Neutrality. This is not a debate about how large our government should be, about what the proper role of government in society is, or about what the priorities of government spending should be. All those issues can be and should be discussed, but not in the context of tax restructuring.

Fairness. Equitable distribution of the tax burden is of paramount importance. We govern a society that worries about all of its citizens, not just the successful ones, and to that end, we should maintain the current progressivity that provides some relief for the least well-off among us.

Simplicity. Both individuals and businesses resent and complain about the level of complexity of the current tax system. Taxpayers worry that they are being unfairly taxed and that others have found ways to avoid the tax. Extensive and lucrative industries of lawyers, accountants, and tax preparers spend countless hours and unbounded energy helping taxpayers through the maze of complexity to minimize their tax liabilities. A simpler tax system would free up these resources to engage in more productive economic enterprises. A simpler system would be better understood by the average citizen and, thus, would avoid the ill will and skepticism generated by

the current system. A simpler system would improve compliance and streamline administration.

Many alternative tax systems purport to be simple, but a close examination of the details belies that claim. One of the reasons I believe my proposal is preferable to others is that it has almost no special exemptions or deductions and it has only one rate. This is very important to achieving the simplicity for which we all strive.

Economic Efficiency. A good revenue system should minimize interference in economic markets. It should result in the least amount of distortion and bias, should encourage economic growth, and should promote the vigor and competitiveness of American companies. Complying with a good revenue system should be straightforward and not too costly. A simpler, less burdensome, more neutral tax system would provide opportunities for more efficient use of our Nation's resources. That would be to the benefit of all Americans and would improve the future standards of living of our children and grandchildren. In our examination of alternative tax systems, we must keep this goal in the forefront and make sure that every decision we make along the way furthers this goal.

International Competitiveness. The current income tax is an impediment to maximum competitiveness of American companies in international markets. Our income tax simply has not kept up with the many changes that have occurred in the global marketplace. Income taxes cannot be removed from the price of goods when they cross the border to be exported. The current system penalizes exports because under the rules of the World Trade Organization (WTO), formerly the General Agreement on Tariffs and Trade (GATT), only indirect taxes, such as a VAT, can be adjusted at the border. A border-adjustable tax system would promote the competitiveness of American companies and invigorate American exports.

Discussion Draft of a New Revenue System:

The VALUE-ADDED TAX

The centerpiece of a comprehensive program to reform the Federal Government's revenue system should be a broadly based and uniformly applied value-added tax (VAT). The following is an outline of the principal features of a potential tax system:

- **BUSINESSES ARE TAXPAYERS**

Businesses (i.e., corporations, partnerships, and sole proprietorships) would be required to collect the tax. The business itself would be responsible for filing periodic returns and remitting the tax. For sole proprietorships, the individual owner would be responsible. Other individuals would not be subject to collecting or remitting the VAT.

- **ONE TAX RATE**

There would be a single tax rate applied to all businesses (including government businesses). The rate would be a function of the desired revenue level to replace the repealed taxes.

- **BROAD TAXABLE BASE**

The taxable amount for each business would be its economic "value-added," which equals the excess (if any) of its receipts from sales of goods and services over its payments for purchases of goods and services from other businesses. Sales of all goods and services by businesses would be included in the system (except exports, as discussed below), including all professional services, financial services, food and beverages, medical services and products, new houses, and rental housing. No businesses would be "exempted" from the system.

- **SUBTRACTION METHOD OF COMPUTING TAX LIABILITY**

The tax would be computed using the subtraction method. Gross receipts from sales of goods and services would be the tentative taxable amount. Gross costs for purchases of goods and services would be deducted from that amount. The balance would be the business' value-added base, which would be multiplied by the tax rate to determine the tax liability. If the balance is negative because purchases exceeded sales for that period, the business would receive a refund equal to the balance multiplied by the tax rate.

- **BORDER ADJUSTMENTS**

Imports. The tax would apply to sales of imported goods and services. This should be done in a manner which imposes the least administrative costs while assuring the highest rate of compliance.

For goods, the options include:

(1) payment by the seller or purchaser when goods enter the country at customs locations, with a subsequent deduction by the purchaser for the cost of the goods, or

(2) denial of a deduction by the purchaser for the cost of the goods.

For imported services (with the possible exception of transportation services for imported goods), the only workable option probably is (2) above.

Exports. The tax would not apply to sales of goods or services for export. A business which sells goods for delivery outside the U.S. (or, in general, services for use outside the U.S.) would exclude such sales when computing its taxable base while still deducting all purchases.

- **TREATMENT OF PARTICULAR BUSINESSES**

Housing Sectors. Sales of houses by businesses such as builders, developers, renovators, etc., would be included in the system, just like sales of all other goods by businesses. Renovation and remodeling services would also be included. Rentals by landlords would be included. Resales of houses by homeowners would not be subject to the tax.

Financial Intermediaries. The financial intermediation services of businesses such as banks and insurance companies would be included in the system, just like all other services. In general, their gross sales of services would be limited to the "spread" between the sum of interest, premiums, and investment income received (from borrowers, insureds, and investments) and the sum of interest and claims paid (to depositors and insureds), plus identifiable fees for specific services and other sales receipts.

Governments. Sales of goods and services to governments would be included in the system. Governments should not be exempt from the tax for their sales of goods and services.

Non-Profit Entities. Sales to non-profit entities would be included in the system. These entities should not be exempt from the tax for their sales of goods and services.

Agricultural Enterprises. Agricultural enterprises would be included in the system.

Leasing Companies. Receipts of businesses which lease and rent goods would be included in the system.

- **TREATMENT OF PARTICULAR GOODS AND SERVICES**

Used Property. The receipts from sales of used machinery, equipment, and other property that has been previously deducted by a business would be included in that business' gross sales receipts.

Leased Property. Payments for leased property would be deductible by the lessee business.

Intangible Assets. The receipts from sales of intangible assets such as patents, copyrights, trademarks, etc., would be included in gross sales receipts. Purchases of such intangibles would be deductible by the purchasing business.

Steps to Tax Reform:

The Gibbons proposal represents a major change in our revenue system. There are three basic steps:

Step 1. Repeal of the individual and corporate income taxes and most payroll taxes. Wage-earners would no longer be subject to FICA (social security) taxes on their first dollar of earnings. They would not see their gross paychecks shrink, as they do today because income and FICA taxes are withheld today. Their net paychecks would equal their gross earnings. Businesses would no longer pay the corporate income tax.

Step 2. Imposition of a single-rate, subtraction-method value-added tax on businesses. This would be collected at the business level only. Every incorporated and unincorporated business would be subject to this system.

The rate would be set to raise only sufficient revenue to replace the current income and payroll taxes. Businesses only would collect and remit the tax, as I illustrate in the attached "Description of Value-Added Tax Form" later in this document. Most of these calculations required would be made anyway in the ordinary course of business.


It is important to point out that this system is not a national retail sales tax. A sales tax is applied as a set percentage of the *retail* price of goods and services. On the other hand, a value-added tax is levied at each stage of production only on a firm's *net* value-added.

Step 3. Adjustments to the resulting tax burden would be necessary to maintain the current distribution of the Federal tax system. Any new tax system should result in the same tax burden on each income group as the current tax system imposes.

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Congressman Sam M. Gibbons
Ranking Democrat, Committee on Ways and Means
June 6, 1996

Form VAT U.S. Value-Added Tax Return 1996		FOR BUSINESSES ONLY	
<div style="border: 1px solid black; padding: 5px; width: fit-content; margin: 0 auto;"><p>Business Name 1234 Main Street Anytown, USA 10000</p></div>			
Receipts	1.	Gross Sales	1. _____
	2.	Receipts from exports	2. _____
	3.	Total gross receipts (subtract line 2 from line 1)	3. _____
Purchases	4.	Gross Purchases	4. _____
	5.	Import purchases	5. _____
	6.	Subtract line 5 from line 4. This is your total purchases	6. _____
Value-Added Tax	7.	Total Value-Added (subtract line 6 from line 3)	7. _____
	8.	Multiply line 7 x 20%. This is your total tax	8. _____
	9.	Tax due (if line 7 is a positive number)	9. _____
	10.	Refund due (if line 7 is a negative number)	10. _____
Sign Here		 _____	

Description of the Value-Added Tax Form

Under the VAT, businesses would no longer be required to:

- **File consolidated income tax returns** for purposes of the existing corporate tax. This involves elaborate record keeping for inter-company transactions. Complex rules govern the extent to which the losses of a subsidiary can be used to offset income of the other members of the group. Under my value-added tax, the only computations on a consolidated basis would be computations of gross sales and business purchases. This could simply be accomplished by not taking into account sales and purchases between members of the group.
- **Maintain inventories.** Currently, companies must keep records of amounts in inventory and allocate expenses between amounts that have to be capitalized as part of inventory and those that can be expensed as overhead. In addition, companies using the LIFO method must maintain elaborate records as to the various layers of its inventory. None of this is required under my proposed value-added tax.
- **Capitalize and then depreciate acquisitions of plant and equipment.** Currently businesses are required to distinguish between items such as repairs, which can be immediately expensed, and other items which are betterments or improvements and must therefore be capitalized and depreciated. They must maintain records as to the depreciable basis of each asset. None of this would be required under the value-added tax. All amounts for acquisitions or improvements of property would be immediately expensed.
- **Deal with all of the enormous complexity involving the foreign tax credit.**

The VAT would be collected and remitted only by businesses and would require fewer than a half dozen simple computations, many of which would be made whether or not there was a value-added tax.

On line 1, the business would be required to compute its gross business sales. In determining this amount, the business would include the following amounts:

- Sales of goods and services produced or sold in the course of its business;
- Amounts (such as rents or royalties) received for granting the right to use property (whether tangible or intangible); and
- Amounts received from sale of assets which were used in the business.

Respectfully submitted!
Sam M. Gibbons
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